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November 13, 2007

### **AGENDA ITEM 3**

**TO: MEMBERS OF THE INVESTMENT COMMITTEE**

- I. SUBJECT:** Policy Subcommittee Report
- II. PROGRAM:** Total Fund
- III. RECOMMENDATION:**
  - a. Approve the Revision of Glossary Definition of Global Equity Emerging Markets
  - b. Approve the Revision of Policy on Manager Development Program I and II (MDP) Manager Transition
  - c. Adopt the Policy on Emerging Equity Markets Principles and Repeal the Policy on Permissible Equity for Emerging Equity Markets
  - d. Approve the following revised Investment and Risk Management Policies:
    - 1) Derivatives – Investment Office (new title – Development of Derivatives Strategies)
    - 2) Derivatives – External Money Managers
    - 3) Developmental Investment Fund
    - 4) Risk Management
    - 5) Securities Lending
    - 6) Credit Enhancement Program
  - e. Approve the following revised Operations Policies:
    - 1) Custody Management
    - 2) Directed Brokerage Arrangement

#### **IV. ANALYSIS:**

##### **Background**

The Policy Subcommittee met on October 12, 2007, and reviewed proposed revisions to several Global Equity policies. In addition, the Subcommittee reviewed proposed revisions to Investment and Risk Management, and Operations Policies, as part of the Policy Review Project. The Subcommittee recommended that the Investment Committee approve revisions to these policies, as set forth below.

The proposed revised policies are attached. Unless otherwise noted, they are presented as black-lined versions from the last adopted policy by the Investment Committee. The black-line uses strike-out to indicate deletions and double underline to indicate additions. Single underline does not indicate a change; rather, it indicates that the term is defined in the glossary.

#### **REVISIONS TO GLOBAL EQUITY POLICIES**

##### **Approve the Revision of Glossary Definition of Global Equity Emerging Markets (tab 3a)**

At the request of the Policy Subcommittee, staff reviewed the current definitions for Emerging Markets. Staff recommended to the Subcommittee a revised definition for Global Equity Emerging Markets. The Subcommittee is recommending this revised definition to the Investment Committee.

In addition, the Subcommittee discussed the need for definitions of the term “emerging markets” as used in other asset classes. Staff will report on this at a future date and will also provide a comparison (or matrix) of the definitions and policies across asset classes.

##### **Revision of Policy on Manager Development Program I and II (MDP) Manager Transition (tab 3b)**

Recently, the CalPERS Investment Committee approved a revision to the MDP II partners' investment charters. This revision expanded the permitted investments to include externally managed strategies in CalPERS' public markets programs, excluding hedge funds and funds of emerging hedge funds. The proposed revisions to the policy reflect this change.

In addition, the policy was expanded to cover the MDP Program, as well as manager transitions. Consequently, the policy name has been revised to Manager Development Program I and II (MDP) Policy and Manager Transition Policy.

The Subcommittee recommends approval of the revised policy.

**Adoption of Policy on Emerging Equity Markets Principles and Repeal of Policy on Permissible Equity for Emerging Equity Markets (tab 3c)**

The CalPERS Investment Committee, at its August 13, 2007 meeting, approved a principles based approach to investing in the emerging markets in lieu of the existing country list and permissible equity markets analysis. To implement this decision, Staff recommended to the Subcommittee adoption of the Statement of Investment Policy for Emerging Equity Markets Principles, and the repeal of the Statement of Investment Policy for Permissible Equity for Emerging Equity Markets.

This new principles based approach continues CalPERS' policy of being a positive influence for improved practices in emerging markets, while increasing the opportunity set for CalPERS' managers and providing a potential reduction in the volatility of CalPERS' emerging markets returns. In addition, adopting the principles based approach in lieu of a country list results in cost savings of approximately \$1 million per year.

The Subcommittee recommends approval of the Staff recommendation, with changes requested at the Subcommittee meeting. The requested Subcommittee changes are shown in blackline.

**POLICY REVIEW AND CONSOLIDATION PROJECT**

The objectives of the Policy Review Project are (1) to organize and streamline Investment Policy to improve access, clarity and transparency, (2) to provide a consistent Investment Policy framework, and (3) to ensure that the policies will facilitate the on-going CalPERS compliance program.

The Policy Review Project entails a detailed review of each policy with an eye toward updating and streamlining the policy, as well as potential consolidation with other related policies. In addition to these goals, the review and revisions include the following:

- Removal of delegations from policy. During the Delegations Project, staff reviewed all policies, minutes, and delegations to identify and consolidate delegations. Delegations are now located in consolidated documents.
- Removal of operational and procedural language, which is now located in staff internal procedure manuals.
- Conformance to the new template.

The project is a joint effort and includes input from the General Pension Consultant, the CalPERS Legal Office, and the Enterprise Office of Compliance.

Clean and blacklined versions are provided for each policy. As a general rule, the revised policies have not been changed substantively. Substantive changes that were deemed necessary and appropriate have been highlighted for the Committee's convenience.

### **Revision of Investment and Risk Management Policies**

Most of these policies were previously located within the asset class sections of the Policy Manual and have been moved to the newly formed *Investment and Risk Management* category.

The Subcommittee recommends approval of the following revised Investment and Risk Management policies.

- 1) Derivatives – Investment Office (new title – Development of Derivatives Strategies) (tab 3d1)

The policy and title have been revised to clarify that the intent of the policy is to govern the development of derivatives strategies, whether internally or externally managed.

One additional term, structured notes, has been added to the glossary.

- 2) Derivatives – External Money Managers (tab 3d2)

The definition of “derivative,” Section II, was revised to conform to the policy on Development of Derivatives Strategies.

- 3) Developmental Investment Fund (tab 3d3)

Section V. A. 3. f has been edited to clarify that unsuccessful strategies may be terminated at any time. Previously, this limitation had not been explicitly stated.

The policy has been revised so that it applies across asset classes. The Global Equity Approaches and Parameters has been removed from the policy and attached as Appendix A. As other asset classes wish in the future to apply this policy, appropriate language will be added.

- 4) Risk Management (tab 3d4)

The proposed policy contains no substantive changes.

Two new terms have been added to the Risk Management glossary: diversifiable risk (unsystematic risk) and non-diversifiable risk (systematic risk)

5) Securities Lending (tab 3d5)

One substantive change should be noted in Attachment A. II. A. 2. Fixed Income Staff have revised the policy to provide for the use of equities as collateral in repurchase agreements, subject to the limitations set forth in the revised policy.

6) Credit Enhancement Program (tab 3d6)

Staff is eliminating the statement “default on any debt (private or public)” in section V. B. 2. Many defaults in the municipal market are technical defaults and the information is not readily available to the public. Eliminating the statement is not expected to increase the overall credit risk of the Program given that our policy requires issuers to be rated investment grade in order to qualify for credit enhancement.

### **Revision of Operations Policies**

Along with the General Pension Consultant, the Legal Office, and the Office of Enterprise Compliance, the Fiscal Services Division staff also participated in the review of these policies because they share responsibility for implementation of these two policies.

These policies were previously located within the miscellaneous section of the Policy Manual and have been moved to the newly formed *Operations* category.

The Subcommittee recommends that the Investment Committee approve the following revised Operations policies.

1) Custody Management (tab 3e1)

The substantive changes are described below:

- Section II specifies a minimum credit rating threshold or similar assurance of financial soundness for any CalPERS custodial bank.
- Section III.B.1.m requires the custodian to provide third-party verification regarding its internal controls.

Both of these policy changes, which are consistent with CalPERS' existing practices for monitoring our custodian, are intended to provide additional assurances regarding the safekeeping of CalPERS' assets.

2) Directed Brokerage Arrangement (tab 3e2)

Language has been added to clarify that "best execution" concerns are paramount in the implementation of the policy, and that the policy applies both to internally and externally managed assets.

Additionally, three definitions have been added to the glossary for this policy.

**V. STRATEGIC PLAN:**

This item supports Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.

**VI. RESULTS/COSTS:**

The results of this item will provide CalPERS with enhanced efficiencies and ability to manage the overall portfolio. The revised policies will provide a foundation for compliance, accountability, and transparency.

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Matt Flynn  
Division Chief

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Anne Stausboll  
Chief Operating Investment Officer